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Executive Secretary

4/11/83

Date

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THE WHITE HOUSE
WASHINGTON

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CABINET AFFAIRS STAFFING MEMORANDUM

DATE: 4/8/83 NUMBER: 118612CA DUE BY: ______

SUBJECT: Cabinet Council on Economic Affairs - Tuesday, April 12, 1983
8:45 a.m. Roosevelt Room

	ACTION	FYI
ALL CABINET MEMBERS	☐	☐
Vice President	☑	☐
State	☑	☐
Treasury	☑	☐
Defense	☐	☑
Attorney General	☐	☑
Interior	☐	☑
Agriculture	☑	☐
Commerce	☑	☐
Labor	☑	☐
HHS	☐	☑
HUD	☐	☑
Transportation	☑	☐
Energy	☐	☑
Education	☐	☑
Counsellor	☑	☐
OMB	☑	☐
CIA	☐	☑
UN	☐	☑
USTR	☑	☐
CEA	☑	☐
CEQ	☐	☐
OSTP	☐	☐
______	☐	☐
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	ACTION	FYI
Baker	☑	☐
Deaver	☐	☐
Clark	☐	☑
Darman *(For WH Staffing)*	☑	☐
Harper	☑	☐
Jenkins	☐	☑
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CCCT/Gunn	☐	☐
CCEA/Porter	☑	☐
CCFA/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/Boggs	☐	☐

REMARKS: The Cabinet Council on Economic Affairs will meet Tuesday, April 12, 1983 at 8:45 am in the Roosevelt Room. Agenda and papers are attached.

General Revenue Sharing/CM357 — paper distributed 4/1/83

Economic Consequences of a Strong Dollar/CM#052 — paper attached

Farmers Home Lending/CM#113

APR 8 8 58 AM '83

ER

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☑ Becky Norton Dunlop
Director, Office of
Cabinet Affairs
456-2800

THE WHITE HOUSE

WASHINGTON

April 8, 1983

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM: ROGER B. PORTER RBP

SUBJECT: Agenda and Papers for the April 12 Meeting

The agenda and papers for the April 12 meeting of the Cabinet Council on Economic Affairs are attached. The meeting is scheduled for 8:45 a.m. in the Roosevelt Room.

The first agenda item is the administration's position on reauthorizing general revenue sharing. This continues the Council's discussion of this issue at the April 5 meeting. The paper for this agenda item was distributed to Council members on April 1.

The second agenda item is a review of the economic consequences of a strong dollar. At the March 15 meeting the Council raised this issue and requested Martin Feldstein to prepare a paper on it to serve as the basis for discussion. The paper prepared by Martin Feldstein is attached.

If time permits, Secretary Block will present a brief report on the economic impact of Farmers Home Administration lending.

Attachments

THE WHITE HOUSE

WASHINGTON

THE CABINET COUNCIL ON ECONOMIC AFFAIRS

April 12, 1983

8:45 a.m.

Roosevelt Room

AGENDA

1. Reauthorization of General Revenue Sharing (CM#357)

2. Economic Consequences of a Strong Dollar (CM#052)

3. Economic Impact of Farmers Home Lending (CM#113)

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

April 8, 1983

MEMORANDUM FOR THE CABINET COUNCIL ON ECONOMIC AFFAIRS

FROM MARTIN FELDSTEIN

SUBJECT: Is the Dollar Overvalued?

Introduction

The notion that the dollar is overvalued has become a commonplace assertion in discussions of the international position of the American economy. American businessmen point to an overvalued dollar as the primary reason for their loss of overseas markets and their problems in competing with imports from abroad. Officials of foreign governments also assert that the dollar is overvalued and often suggest that the United States should join with other nations to prevent the type of currency fluctuations that have caused the dollar to be overvalued. This idea of stabilizing the exchange value of the dollar is also mentioned with increasing frequency in this country.

Although the idea of an overvalued dollar is rapidly becoming part of today's conventional wisdom, the notion of an overvalued dollar is very difficult to define and even more difficult to defend. Just what does it mean to say that the dollar is overvalued? In the years before 1973, when exchange rates were fixed by government intervention, the notion of an overvalued currency had a clear operational meaning: the dollar was overvalued if permitting it to float freely would cause its value to fall relative to other currencies. In other words, the exchange rate in a free market was the standard by which to judge whether an historically fixed exchange rate was currently overvalued or undervalued.

Such an interpretation is no longer applicable. The dollar now floats freely relative to the other major currencies of the world and its value reflects the balance of supply and demand for dollars. By the traditional standard, it is as meaningless to say that the dollar is overvalued as it is to say that apples or typewriters are overvalued.

The Dollar and the U.S. Trade Balance

Some of those who now assert that the dollar is overvalued no doubt mean that the current exchange rate fails to balance imports and exports. In 1982, the value of merchandise imports into the United States exceeded the value of merchandise exports from the United States by $36 billion, a record amount. Moreover, experts predict that this year's export-import imbalance, known technically as the merchandise trade deficit, may exceed $60 billion. A lower value of the dollar relative to other currencies would encourage more exports and would reduce imports, thereby shrinking the trade deficit toward zero.

But why should a balance between goods exported and goods imported be a standard for judging whether the dollar is appropriately valued? Individuals and firms in this country also receive payments for services sold to foreigners (e.g., banking, insurance and transportation services) and, even more important, earn interest and dividends on overseas investments. Last year, the net sale of services and the earnings on foreign investments together offset virtually the entire merchandise trade deficit. Pension payments and other unilateral payments were responsible for essentially all of what is known as the "current account deficit" of about $8 billion that had to be financed by borrowing from abroad or by reducing U.S. investments overseas and by selling U.S. assets to foreigners.

This year, the current account deficit may exceed $25 billion. A country cannot expect to go on running a current account deficit forever. Over time it must earn enough from sales or investment income to pay for its purchases from the rest of the world. It is tempting, therefore, to say that the dollar is overvalued if it leads to a current account deficit. By that standard, the dollar is currently overvalued.

But why should we expect or want a current account balance in every year? For the three decades from the end of World War II through 1976, the United States had a current account surplus in nearly every year and accumulated a substantial stock of overseas investments. Although the dollar must eventually adjust to cause a long-run current account balance, there is no reason for it to do so this year, or next year, or any time in the near future. The conclusion that the dollar may be overvalued in some long-run sense does not imply anything about its appropriate value in the current year.

Since the notion that the dollar's value is too high cannot be defined by reference to an objective standard, it must have a normative meaning; that is, those in this country who say that the dollar is too high must believe that a lower value of the dollar relative to other currencies would be beneficial to the United States economy. It is, of course, one thing to believe that a lower value of the dollar would be beneficial and quite another to believe that it would be appropriate to take whatever policy actions would be needed to lower the dollar's value.

How High is the Dollar?

The widespread interest in the dollar's value is in large part a response to the dollar's substantial rise in the past two years and to the resulting trade deficit. For example, the German mark was worth 55 cents in 1980 and is now worth only 41 cents. Relative to the D-mark, the dollar has appreciated 34 percent. Moreover, over this same period, domestic prices in Germany rose less than domestic prices in the United States. As a result, the real exchange rate -- that is, the exchange rate adjusted for the changes in the purchasing power of the domestic currencies -- rose approximately 40 percent since 1980. This means that a dollar now buys 40 percent more German goods, relative to its purchasing power in American goods, than it did about two and a half years ago.

The German experience was rather typical of the worldwide rise in the dollar's value. The multilateral trade-weighted real value of the dollar -- a measure that averages the real exchange rates between the dollar and other currencies in proportion to the amounts of trade -- rose 36 percent between 1980 and the end of 1982.

Much of the concern about the dollar's value focuses on the exchange rate with the Japanese yen. The current exchange rate of 240 yen to the dollar is about 7 percent higher than the 1980 rate of 225 yen to the dollar. After adjusting for the faster rate of inflation in the United States than in Japan, the real value of the dollar has risen 17 percent relative to the yen.

The consequence of the generally higher real value of the dollar has undoubtedly been a fall in U.S. exports and a rise in our imports. Coming on top of the severe recession that now depresses the demand for our exports in other industrial nations and the financial problems that are now forcing the developing countries to contract their imports, the strong dollar has led to the largest trade deficit that our country has ever known.

Why is the Dollar so High?

To assess whether it would be desirable to have a lower value of the dollar, one must first ask why the dollar is so high. The key to understanding the dollar's value is recognizing that the dollar is a portfolio asset for international investors and, like stocks and bonds, will only be held if it can be expected to provide a rate of return as high as the return available on other assets. A rise in the real interest rate on dollar securities will increase the dollar's value. The longer that the interest rate rise is expected to last, the greater will be the dollar's rise. Since the yield on bonds reflects the expected future yields on short-term assets, the rise in the real long-term interest rate is the principal reason for the dollar's appreciation.

To understand why this is so, it is useful to look at the way in which a rise in the U.S. real interest rate affects the exchange rate between the dollar and the German mark. An increase in the interest rate on U.S. Treasury bills makes them a more attractive investment to a German investor. To increase his investment in U.S. Treasury bills, the German must exchange marks for dollars and then use the dollars to buy Treasury bills. This increased demand for dollars raises their value relative to the mark.

How high will the dollar rise? There are two separate factors that limit the increase in the dollar. First, uncertainty about the future dollar-mark exchange rate limits the amount of dollar assets that German investors want to hold. Second, and more fundamental, the German investors know that any rise that occurs in the dollar's value must eventually be reversed as the gap between the dollar interest rate and the interest rate in Germany narrows and returns to its original value. This anticipated fall in the exchange value of the dollar reduces the German investor's total rate of return on dollar securities. Indeed, abstracting from the problem of uncertainty, the dollar will rise until the anticipated rate of decline in the exchange value of the dollar just offsets the higher dollar interest rate.

A rise in the long-term dollar interest rate means in effect a higher rate of interest for many years to come. For each future year, the exchange value of the dollar must be expected to decline by enough to offset the higher interest rate. Thus, whenever the real long-term interest rate increases, the dollar must rise by enough to permit its value to fall in future years and still leave it ultimately at a level that is consistent with long-run current account balance. The greater the rise in the real long-term interest rate, the greater will be the initial rise in the dollar.

Changes in the real interest rate reflect changes in the supply and demand for funds. The primary reason for the recent rise in the real long-term interest rate in the United States is the prospect of large budget deficits in the coming years.

If there are no legislative changes, the budget deficits will be about six percent of GNP for the remainder of the 1980s. To put this number in perspective, note that net private savings have averaged only seven percent of GNP during the past two decades. A budget deficit equal to six percent of GNP would thus absorb an amount equal to virtually all net private savings. To shrink net private investment to the funds available after this government borrowing, the real interest rate would have to rise substantially. It is the anticipation of these future real interest rates that is reflected in the real long-term rate on bonds and that keeps the dollar's value high.

Capital Inflows

To summarize, the currently anticipated budget deficits cause high real interest rates which raise the exchange value of the dollars and thereby cause an enlarged trade deficit. In short, budget deficits beget trade deficits and this requires a high exchange value of the dollar.

The current trade deficit and the resulting current account deficit mean that the United States will be a net capital importer this year and may continue to be one for several years to come. These capital inflows add to domestic saving and help to finance domestic investment. In 1983, the current account deficit is likely to correspond to a capital inflow equal to approximately one percent of GNP, a very significant sum in relation to the net national saving of less than two percent of GNP even if it is small in comparison to this year's budget deficit of more than six percent of GNP.

Would it be desirable to have a lower exchange value of the dollar? A weaker dollar would raise exports and reduce the substitution of imports for domestically produced goods. As such, it would be welcomed by those U.S. industries that are now being hurt by the strength of the dollar.

But a weaker dollar and smaller trade deficit would also mean less capital inflow from the rest of the world and therefore a lower level of domestic investment in plant and equipment and in housing. The rise in the dollar is a safety valve that reduces pressure on domestic interest rates; the increase in the trade deficit allows the extra demand generated by the budget deficit to spill overseas instead of crowding out domestic investment.

The question of whether it would be desirable to have a lower valued dollar is equivalent to asking whether it is better to allow the temporary increase in the budget deficit to reduce domestic investment and interest-sensitive consumer spending or to reduce the production of goods for export and of goods that compete with imports from abroad. The answer to this question is clear in principle: it is better to reduce exports and increase imports.

Why? Since a temporary increase in the budget deficit implies no change in the profitability of domestic investment, there is no reason to reduce domestic spending on capital formation. Similarly, since a temporary increase in the budget deficit implies only a temporary fall in the resources available for private consumption, it would be inappropriate to reduce consumption immediately by the full amount of the increased annual deficit. Instead, the reduction in consumption should be spread over future years and the temporary budget deficit should be financed by borrowing from abroad, i.e., by a deficit in the current account.

In this way, the appropriate response of the nation to a temporary increase in the budget deficit is analogous to the appropriate response of a small businessman to an unexpected business expense. It would be wrong for him to reduce his business investment or to pay for the entire expense out of his current year's consumption. Instead, he should spread the reduction in consumption over a large number of years and pay for the original expense by borrowing. For the nation as a whole, that borrowing is equivalent to an inflow of capital from abroad and therefore to a current account deficit.

So much for what would in principle be desirable. Note that the actual response of the current account deficit to the increase in the budget deficit has been much smaller than this line of argument suggests might be appropriate. Instead of relying almost entirely on foreign borrowing to finance the budget deficit, the current account deficit and the associated net inflow of foreign funds is only a small fraction of the increased budget deficit. By this standard, the rise in the interest rate has been too great and the rise in the dollar has been too small.

There are, of course, further considerations that complicate the desirable response of the dollar to a temporary rise in the budget deficit. The fall in exports and the rise in imports that result from the stronger dollar are clearly causing unemployment and threatening individual firms with possible bankruptcy. Perhaps these adverse effects are more severe than those that would result from an equal decrease in the demand for plant and equipment, housing and other interest-sensitive goods. Perhaps the firms involved in international trade are more concentrated, or less capable of responding to fluctuations in demand, or less likely to survive until demand returns to its previous level. If so, a lower value for the dollar might be desirable. But at present the burden of proof lies with those who would claim that the industries involved in international trade are more vulnerable and are therefore deserving of special protection.

Expansionary Monetary Policy

The case against policies aimed at reducing the dollar's value is reinforced by considering the measures that would be pursued to achieve a reduction in the dollar's value. To reduce the dollar's value relative to other currencies, the Federal Reserve would sell dollars and buy foreign currencies. A direct effect of such transactions would be to increase the supply of money and therefore to cause an increased rate of inflation in the United States. Although it is sometimes argued that this adverse effect can be avoided by substituting Treasury bills for money, neither economic logic nor empirical evidence supports the view that such transactions -- known as sterilized intervention in foreign exchange markets -- can alter the value of the dollar.

The basic fact is that the value of the dollar can be changed only by modifying the goals for our domestic economy. A lower value of the dollar requires an expansion of the money supply that increases the rate of inflation.

It is not easy therefore to conclude that it would be appropriate to lower the value of the dollar. In addition to establishing that a lower value of the dollar is itself desirable, it would also be necessary to conclude that the advantage of a lower dollar outweighs the disadvantage of the increased inflation that would be required to lower the dollar's value.

Conclusion

This paper has stressed the negative conclusion that it would be wrong to pursue policies aimed at lowering the value of the dollar. There is, however, a more fundamental and positive implication of this analysis. The only appropriate way to reduce our structural deficit in international trade is by reducing the budget deficit that is its basic cause. If the budget deficit is reduced, the real long-term interest rate will fall and this will reduce the pressure that keeps the dollar so high.

The Administration has proposed a five-year budget plan that would decrease future deficits by a balanced combination of reduced spending and increased taxes. It is now time for Congress to work with the Administration to enact the legislation that will assure financial investors and others that the budget deficit will indeed shrink in the years ahead. When such legislation is enacted, we will see declines in the long-term interest rate, a reduction of the dollar, and levels of exports and imports that permit a more widespread and balanced economic recovery.